

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]: [REDACTED]: [REDACTED]: TL-N-3582-99
[REDACTED]

date:

to: Chief, Examination Division, [REDACTED] District
Case Manager [REDACTED] and Team Coordinator [REDACTED]

from: [REDACTED]
Special Litigation Attorney

subject: [REDACTED]
Capitalization of Maquiladora Contract Costs

DISCLOSURE STATEMENT

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Specifically, if this memorandum is addressed to a District Director's office or to another Counsel office, then only office personnel working the specific case or subject matter may use this document. This memorandum shall not be disclosed or circulated beyond such office personnel having the requisite "need to know".

This memorandum is in response to your request for advice concerning the following issue:

ISSUE

Should costs incurred by [REDACTED], that are directly associated with Assembly and Technical Assistance Agreements entered into with corporations formed in Mexico (Maquiladoras) be capitalized and amortized over the life of the contracts?

CONCLUSION

Yes. The Assembly and Technical Assistance Agreements

entered into with the Maquiladoras are capital assets with useful lives equal to the length of the contracts. Accordingly, costs directly associated with those contracts should be capitalized and amortized over the life of the contracts.

FACTS

[REDACTED] (taxpayer) is a foreign controlled corporation with its principal offices located in [REDACTED]. Taxpayer is in the business of the manufacture and sale of [REDACTED] systems.

Prior to [REDACTED], management of taxpayer made the decision to transfer all or a substantial portion of its manufacturing and assembly operations to Mexico. On [REDACTED], taxpayer entered into agreements, called Assembly and Technical Assistance Agreements, with [REDACTED] Mexican corporations (Maquiladoras) previously formed by taxpayer. The agreements were drafted in a very general manner and simply obligated the Maquiladoras to assemble or manufacture [REDACTED] products for taxpayer in amounts as requested by the taxpayer. [REDACTED] was to supply the raw materials, knowhow and other technical assistance. In return, [REDACTED] was to pay the Maquiladoras on a cost plus [REDACTED] per cent mark up for the finished products. The agreements had a [REDACTED] year term, however, could be terminated early at the election of either party with sixty days written notice.

Under the agreements the Maquiladoras were required to use manufacturing and assembly equipment provided by taxpayer. To give effect to the contracts, taxpayer shut down an operating plant in [REDACTED], and disassembled the equipment. The taxpayer then shipped the equipment to Mexico to the facilities of the Maquiladoras. The taxpayer then reassembled the equipment for use by the Maquiladora companies. All of the costs of disassembly, transportation and reassembly were incurred by the Taxpayer. The expenses for disassembly, transportation and reassembly were booked to several different accounts.

Taxpayer also incurred large expenses for feasibility studies for the operations in Mexico. These expenses were booked in an account entitled "[REDACTED]" and totaled \$[REDACTED] in [REDACTED] and [REDACTED] in [REDACTED].¹ The feasibility studies may have included studies of other proposals that were

¹ Other expenses may have been booked to this account, however there is insufficient detail to make this determination.

considered and rejected by management. There is insufficient detail in the information provided to make this determination.

As stated above, in conjunction with moving its operations to Mexico, Taxpayer shut down its manufacturing and assembly operations in [REDACTED]. Taxpayer incurred substantial expenses in shutting down the plant including severance payments to employees and clean up costs for the building. Taxpayer sold the building and incurred a book loss of \$ [REDACTED] in [REDACTED].

Taxpayer deducted all of the above-described expenses on its [REDACTED] and [REDACTED] income tax returns. These expenses are currently under scrutiny by the Examination Division.

DISCUSSION

It has long been held that a contract is an asset, the reasonable costs of which are subject to amortization over the life of the contract. Stewart Title Guaranty Company v. Commissioner, 20 T.C. 630 (1953). Moreover, it has specifically been held that a favorable supply contract with a limited useful life and ascertainable value separate and apart from goodwill is a valuable asset that must be capitalized and amortized over the life of the contract. Ithaca Industries, Inc. v. Commissioner, 97 T.C. 253 (1991).

Based upon the forgoing, the Assembly and Technical Assistance Agreements described above are amortizable assets of value having a useful life of ten years. The fact that the contracts are valuable assets is assumed due to the fact that the Taxpayer would not have incurred the substantial expenses of moving its operations to Mexico, if it did not expect a positive return on investment. The question that now remains is what costs should be included as "reasonable costs" of the contracts.

In my view, the cost of disassembly, transport and reassembly of the equipment required to be used by the Maquiladoras is a direct cost of the contracts that should be capitalized in the contracts' costs. In addition, the cost of the feasibility study and any related studies and legal, engineering or consulting fees for the alternative adopted by management should be capitalized into the cost of the contract. Note that any of these costs associated with alternatives that were rejected by management would most likely be deductible

under I.R.C. 165 as abandonment losses. Any other similar costs that were incurred to directly aid in making the contracts operational may also be capitalized.

In our preliminary discussions of this case, we also discussed possible capitalization of the Taxpayer's plant shutdown costs, severance payments and the loss on the sale of the [REDACTED] facility. For the following reasons, I do not recommend that these expenses be capitalized as costs of the contracts. The severance payments are currently deductible as those expenses are more closely associated with past service of employees than with the costs of entering into the contracts at issue herein. In addition, the loss on the sale of the [REDACTED] facility is a realized and recognized loss that was not necessarily incurred to enter into the contracts. The taxpayer could have kept the facility and converted it to another use. Similarly, the shutdown costs should not be capitalized in the cost of the contracts. Such costs are associated with preparing the [REDACTED] facility for sale and should be deductible in the period that the facility was sold.

I am forwarding this memorandum to the Office of Assistant Chief Counsel (Field Service) under the ten day significant advice review program. I will advise you of the results of that review. Meanwhile, if you have any questions, please call me at [REDACTED].

[REDACTED]
Special Litigation Attorney

CC: [REDACTED], District Counsel
CC: [REDACTED], Assistant Regional Counsel (TL)
CC: Office of Assistant Chief Counsel (Field Service)